STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS

Date Introduced:	**2/20/01**	Bill No:	**SCA 1X**
Tax:	**Property**	Author:	**Poochigian**
Board Position:	**Support**	Related Bills:	

BILL SUMMARY

This bill would place a constitutional amendment before voters to create a new construction exclusion for certain energy efficiency improvements to real property.

ANALYSIS

Current Law

Under existing law, the construction, installation, or modification of a fixture or improvement to real property that is undertaken for the primary purpose of increasing the energy efficiency of that real property could be considered new construction. The law requires that when new construction occurs the total assessed value of the property must be increased by an amount equal to the added value of the construction.

Currently, no special assessment provisions exist for real property fixtures or real property.

Proposed Law

This constitutional amendment would, subject to voter approval, amend Section 2 of Article XIII A of the California Constitution to provide that the term "newly constructed" does not include the construction, installation, or modification of a fixture or improvement to real property that is undertaken for the primary purpose of increasing the energy efficiency of that real property. For purposes of this paragraph, the energy efficiency of real property is increased if that construction, installation, or modification will result in a reduction in the consumption on that property of heat, process heat, space heating, water heating, steam, space cooling, refrigeration, mechanical energy, natural gas, or electricity.

In General

Property Tax System. Article XIII, §1 of the California Constitution provides that all property is taxable, at the same percentage of "fair market value," unless specifically exempted, or authorized for exemption, within the Constitution. Article XIII A, §2 of the California Constitution defines "fair market value" as the assessor's opinion of value for the 1975-76 tax bill, or, thereafter, the appraised value of property when purchased, newly constructed, or a change in ownership has occurred. This value is generally referred to as the “base year value”. Barring actual physical new construction or a change in ownership, annual adjustments to the base year value are limited to 2% or the rate of inflation, whichever is less. Article XIII A, §2 provides for certain exclusions from the meaning of “change in ownership” and “newly constructed” as approved by voters via constitutional amendments.

New Construction. The constitution does not define the term “new construction." Revenue and Taxation Section 70 defines it, in part, to mean:

- Any addition to real property, whether land or improvements (including fixtures), since the last lien date.
- Any alteration of land or improvements (including fixtures) since the lien date that constitutes a “major rehabilitation” or that converts the property to a different use. A major rehabilitation is any rehabilitation, renovation, or modernization that converts an improvement or fixture to the substantial equivalent of a new improvement or fixture.

With respect to any new construction, the law requires the assessor to determine the added value upon completion. The value is established as the base year value for those specific improvements and is added to the property’s existing base year value. When new construction replaces existing improvements, the value attributable to those preexisting improvements is deducted from the property's existing base year value. (R&T Code §71)

New Construction Exclusions. Over the years, Article XIII A, §2 of the Constitution has been amended to specifically exclude certain types of work from assessment as “new construction.” Consequently, while these improvements may increase the value of the property, the additional value is exempt from taxation.

Proposition	Election Ballot	Subject	R&T Code
8	November 1978	Reconstruction After Disaster	§70(c)
7	**November 1980**	**Solar Energy Systems**	**§73**
23	June 1984	Seismic Safety – Unreinforced Masonry Structures	§70(d)
31	November 1984	Fire Safety Systems	§74
110	June 1990	Disabled Accessibility Improvements – Homes	§74.3

Proposition	Election Ballot	Subject	R&T Code
127	November 1990	Seismic Safety - Retrofitting & Hazard Mitigation	§74.5
177	June 1994	Disabled Accessibility Improvements – All Property	§74.6
1	November 1998	Reconstruction After Environmental Contamination	§69.4

Some constitutional amendments proposing new construction exclusions post-Proposition 13 have, at least initially, failed. Those include:

- Proposition 5 in 1980 to exclude reconstruction after a non-Governor declared disaster and seismic safety new construction exclusion. (Seismic safety exclusions were subsequently approved by Propositions 23 in 1984 and Proposition 127 in 1990.)
- Proposition 7 in 1982 for fire sprinkler systems. (Subsequently approved by Proposition 31 in 1984)
- Proposition 34 in 1984 for additions, alternations and rehabilitation of owner occupied historical homes.
- Proposition 178 in 1994 for water conservation equipment.

Fixtures. A fixture is an item of personal property that once affixed to the property shifts in classification from personal property to real property. A three-part test is used to determine whether an item is a fixture:

1. The manner of annexation or attachment of the property.
2. The degree to which the item is customized to a particular location.
3. The intention of the taxpayer in installing the property.

Business Personal Property. Personal property used in a trade or business is generally taxable, and its cost must be reported annually to the assessor on the business property statement as provided for in Revenue and Taxation Code Section 441. Personal property is not subject to the valuation limitations of Proposition 13. It is valued each lien date at current fair market value.

Generally, the valuation of personal property is based on the acquisition cost of the property. The acquisition cost is multiplied by a price index, an inflation trending factor based on the year of acquisition, to provide an estimate of its replacement cost new. The replacement cost new is then multiplied by a depreciation index, also called percent good tables, to provide an estimate of the depreciated replacement cost of the property (replacement cost new less depreciation). The replacement cost new less depreciation value becomes the taxable value of the property for the fiscal year.

COMMENTS

1. **Sponsor and purpose.** The author is the sponsor of this measure. Its purpose is to ensure that property taxes do not increase after energy efficiency improvements are made.

2. **Real Property, Fixtures, Personal Property, Machinery and Equipment.** New construction is a term applied to the assessment of real property, which includes fixtures. Therefore, this bill would exempt from taxation qualifying improvements if classified as real property or a real property fixture but not provide for its exemption for items classified as personal property. (Personal property exemptions do not require a constitutional amendment.) With property used in a business, determining whether an item should be classified as a real property fixture or personal property is often a difficult task that requires the use of judgment. The classification of property as either a real property fixture or personal property is an area of frequent dispute between assessors and taxpayers because the line of demarcation between real and personal property is not always clear. The exemption of property only if classified as a fixture will likely increase such disputes.

3. **Existing law provides an exclusion for active solar energy systems.** This exemption is found in Revenue and Taxation Code 73, which implements Proposition 7. However certain items, namely, solar water heaters and swimming pool heaters, are excluded.

4. **Most types of improvements made to residential property would not be assessed as new construction under existing assessment practices**. For instance, replacing windows, adding insulation, replacing heating ventilating and air conditioning systems (HVAC), replacing appliances, weatherizing improvements, and more efficient lighting are generally considered normal maintenance and repair. With residential property, an exception would be solar water heaters and swimming pool heaters as previously noted.

5. **Generally, fixtures and real property improvements reported on the annual business property statement would be more likely to be assessable as new construction and thus qualify for the proposed exclusion**. Annual reporting requirements and the audit program related to business, commercial and industrial properties, generally lead to the discovery of these types of improvements.

6. **In addition to energy conservation improvements which will be made solely because of the current high cost of gas and electricity, there are numerous legislative proposals to provide added incentives in the form of income tax credits, sales tax exemptions, grants, and no or low interest loans.** The various

legislative proposals relate to both general and specific types of energy conservation improvements. Examples include:

- Installing real time meters
- Replacing appliances with more energy efficient models
- Retrofitting refrigeration units
- Installing renewable energy systems
- Installing solar energy systems
- Installing thermal energy solar technologies in commercial buildings
- Improving and installing demand responsiveness technologies to HVAC systems
- Installing commercial lighting efficiency technologies
- Retrofitting pumps and motors in oil and natural gas production

COST ESTIMATE

The Board would incur some minor absorbable costs to inform and advise local county assessors, the public, and staff if voters approve this constitutional amendment.

REVENUE ESTIMATE

Background, Methodology, and Assumptions

Under current law, "new construction" includes any physical alteration of an improvement that converts the improvement, or a portion of it, to the substantial equivalent of a new structure or changes the way in which the portion of the structure that was altered is used. "New construction" excludes alterations performed for the purpose of normal maintenance and repair.

Many of the alterations that might be undertaken to increase energy efficiency would fall under normal maintenance and repair. These would include adding insulation, upgrading or replacing windows and doors, replacing heating and cooling systems, weatherization improvements, and installing more efficient lighting. For residential property, energy modifications that may be "new construction" include the addition of a freestanding stove or a fireplace insert. It is difficult to foresee how many modifications like these would take place in the future but it is likely that the number will be very small and that the amount of value added for the new construction would also be small.

For non-residential property, including commercial/industrial and agricultural, energy efficiency modifications that may be classed as "new construction" include installing of new skylights, replacing the lighting system, installing a "false" ceiling, replacing manufacturing equipment, replacing an irrigation system using an electric pump with a drip irrigation system, or replacing the electric irrigation pump with a diesel pump, and replacing dairy equipment. Staff is unable to predict how many of these modifications would take place with the primary purpose to increase the energy efficiency of the property.

Revenue Summary

It is likely that the proposed new construction exclusion for the construction, installation, or modification of any fixture or improvement that is undertaken for the primary purpose of increasing the energy efficiency of the property will have a minimal annual revenue impact. However, due to the varying factors involved and their lack of predictability, it is not possible to quantify the revenue effects of this proposal.

Analysis prepared by:	Rose Marie Kinnee	445-6777	03/19/01
Revenue estimate by:	Aileen Takaha Lee	445-0840	
Contact:	Margaret S. Shedd	322-2376	